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De-risking and the Caribbean
One-page Summary

(1) Correspondent banking is an essential component of the global payment system. Through correspondent banking, banks can access financial services in different jurisdictions and provide cross-border payment services to their customers, supporting international trade and financial inclusion.

(2) In addition, most of the payment solutions that do not involve a bank account at customer level – such as remittances – rely on correspondent banking for the actual transfer of funds.

(3) Small states, like the Caribbean countries, are in danger of losing their correspondent banking connection to the US economy as many large international banks, under pressure (by regulators) to reduce risk and (by investors) to cut costs, have withdrawn from correspondent banking relationships.

(4) The loss of correspondent banking is foremost on the minds of Caribbean leaders who are fearful of the economic consequences of losing their ties to the US banking system.

(5) The loss of correspondent banking is also on the minds of those who care about the ability of the United States to conduct economic statecraft (sanctions). If economies drop out of the US banking system, the US politico-economic relationship with these countries will be diminished.

(6) The loss of correspondent banking is also important to the anti-money laundering/combating the financing of terrorism (AML/CFT) enforcement community, because enforcement is made more difficult when transactions occur outside the banking system.

(7) The solution – especially for small state economies like those in the Caribbean – is to balance the need for AML/CFT enforcement with the need for financial inclusion.

(8) Regulators' response to de-risking is to work with banks and host country regulators toward an enhanced understanding of the de-risking phenomenon; improved data collection; continued dialogue among stakeholders; timely implementation of the Financial Stability Board's 2015 action plan; communication of regulatory expectations; and continued strengthening of regulatory and supervisory frameworks with the help of technical assistance. It is not clear how quickly this approach will produce results.

(9) Two pieces of relevant legislation have passed the House. One (HR 4939) calls for a complete reassessment of the US-Caribbean relationship; the other (HR 5594) calls for a complete reassessment of AML/CFT enforcement strategy. Neither bill directly addresses the critical problem of de-risking.

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September 2016

De-risking and the Caribbean
Six-page Summary

What is correspondent banking and de-risking?

(1) Because the US economy is the dominant world economy, countries outside the US that trade with the US but don't have branch banks in the US, need access to the US banking system to manage cross-border transactions. Correspondent banking is the principle means by which that access occurs.

(2) The US dollar is used for 45 percent of all world payments, followed by the euro at 28 percent and the British pound at nearly eight percent. Without correspondent banking relationships (CBRs), legal access to these currencies for international trade and finance becomes impossible.[1]

(3) Correspondent banking is an essential component of the global payment system. Through correspondent banking, banks can access financial services in different jurisdictions and provide cross-border payment services to their customers, supporting international trade and financial inclusion.

(4) In addition, most of the payment solutions that do not involve a bank account at customer level – such as remittances – rely on correspondent banking for the actual transfer of funds.

(5) Small states, like those in the Caribbean, are in danger of losing their correspondent banking connection to the US economy as many large international banks, under pressure (by regulators) to reduce risk and (by investors) to cut costs, have withdrawn from correspondent banking relationships.

The loss of correspondent banking is foremost on the minds of Caribbean leaders who are fearful of the economic consequences of losing their ties to the US banking system.

(6) The Caribbean Policy Research Institute in its in depth study of the problem, characterized the impact on the Caribbean as follows:

> "The Caribbean region is uniquely susceptible to the effects of de-risking, particularly given its dependence on trade, remittances and foreign direct investment. For example, while trade amounts to one-third of the United States' gross domestic product (GDP), trade is equivalent to almost half the GDP of developing countries of Latin America and the Caribbean (LAC), and almost 100 percent of the GDP in small Caribbean states. De-banking therefore threatens to strangle the supply lines of economic activity with potentially calamitous consequences for economic growth and development in the Caribbean."[2]

[1] http://www.capricaribbean.com/documents/correspondent-banking-problem (p. 12)

[2]https://docs.google.com/viewerng/viewer?url=http://www.capricaribbean.com/sites/default/files/public/documents/report/the_correspondent_banking_problem.pdf

Received by NSD/FARA Registration Unit 09/22/2016 3:36:53 PM

(7) The World Bank, in their definitive study, reported that the decline in correspondent banking has been most severe in the Caribbean[3] where it is viewed by the countries there with growing alarm.[4]

(8) In his statement to the US-Caribbean Public-Private Dialogue on Correspondent Banking, April 5, 2016, the President of the Centrale Bank van Curacao en Sint Maarten, summarized the situation facing the Caribbean:

> "For most Caribbean economies, the United States is one of, if not our most important trading partner. Our island nations generally are small open economies with practically no natural resource base. Therefore, we have to import practically everything. Access to the export markets and our ability to finance those imports become very important to us. ... Ending these relations will seriously affect economic activity in the region, with all of the attendant consequences on social and political stability. ... Our very survival hinges on our ability to import goods and services from our main trading partners."

(9) On March 30, 2016, the last day of his three-month stint as President of the Organization of American States (OAS) Permanent Council, Sir Ronald Sanders convened a panel of experts[5] and held a meeting with representatives of the thirty-four states of the Americas to look at "Finance and Banking Services Challenges to Development in the Americas".

According to Sir Sanders the experts:

> "...left no doubt in the minds of the Ambassadors that all of the countries in the Caribbean and several in Central America are being unfairly targeted as 'high risk areas' for financial services, and that cutting off CBRs has little to do with the risk of money laundering and terrorism financing, and much more to do with the smallness of the rewards global banks receive from doing business with Caribbean banks when those small rewards are measured against possible huge penalties with which they are threatened by regulatory bodies."

His write-up of the meeting can be found here:
http://www.sirronaldsanders.com/viewarticle.aspx?ID=551

(10) Between September and December 2015, the Commonwealth Secretariat conducted a large-scale survey on de-risking among its membership.[6] The survey, published this year, revealed that the area of greatest concern for member governments in relation to anti-money laundering/combating the financing of terrorism (AML/CFT) regulations was the loss of CBRs. While the reasons for closures varied, the majority of Commonwealth developing countries identified decreased profitability resulting from the increased monitoring and compliance costs of AML/CFT regulations as a key driver of de-risking.

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[3] http://documents.worldbank.org/curated/en/2015/11/25481335/withdraw-correspondent-banking (p.13)
[4] http://www.huffingtonpost.com/otaviano-canuto/de-risking-is-de-linking_b_8357342.html See also: http://www.caribbean-council.org/deep-concern-correspondent-banking/ See also: http://www.caribbean360.com/opinion/de-risking-or-destruction-neither-is-fair-sir-ronald-sanders
[5] The experts in attendance were: Ryan Pinder, a former Financial Services Minister in the Bahamian government; Dr. Farah Diva Urrutia, Director General for Legal Affairs and Treaties of the Ministry of Foreign Affairs of the Republic of Panama; Tax treaty expert Dr. Bruce Zagaris; and Dr. Daniel Mitchell, senior fellow with CATO Institute.
[6] http://thecommonwealth.org/disconnecting-from-global-finance

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The report recommended the:

- creation of a global forum for regulators to ensure the incorporation of developing country perspectives in the development of international standards and regulation;
- development of better guidance and risk tolerance standards for banks;
- creation of best practice standards for money service businesses; and the
- enhancement of capacity building to assist regulators and financial institutions in the implementation of AML/CFT regulations.

The loss of correspondent banking is also on the minds of those who care about the ability of the United States to conduct economic statecraft (sanctions). If economies drop out of the US banking system, the US politico-economic relationships with these countries will be diminished.

(11) In a February 2015 speech, Thomas C. Baxter, Executive Vice President and General Counsel of the Federal Reserve, raised the possibility that de-risking might have a "highly consequential" impact on "the role of the dollar as the international medium of exchange."[7]

(12) While, in that speech, Mr. Baxter didn't mention what that impact would be, the Center for New American Security (CNAS) addressed the potential seriousness of this impact head on: the exchange void created by de-risking will be filled by others and, as a consequence, the US could lose, perhaps over a relatively quick period of time, its preeminent position as the de facto leader of the global economy.[8]

From page 47 of the report:

> "…the fear is that China and others are slowly replacing the fundamental architecture of the international financial system in a way that will make it more difficult for the United States to use the tools of economic statecraft to protect its interests and those of the international community in the future. Moreover, the United States and its allies fear that the extent of their powerlessness will be revealed after it is too late to do anything about it, and that it will have non-linear effects on the Western financial system."

The solution is to balance the need for AML/CFT enforcement with the need for financial inclusion.

(13) In November of 2015 the Center for Global Development (CGD) released a report calling for "rebalancing" AML/CFT policies to "continue to protect against money laundering and terrorism financing without hindering the ability of people from poor countries to conduct business and transfer money across borders."[9]

The report also concluded that regulators' AML/CFT policies "may be undermining the effectiveness of the AML system by pushing transactions into less transparent channels."[10]

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[7] https://www.newyorkfed.org/newsevents/speeches/2015/bax020915
[8] http://www.cnas.org/sites/default/files/publications-pdf/CNASReport-EconomicWarfare-160408v02.pdf
[9] http://www.cgdev.org/working-group/unintended-consequences-anti-money-laundering-combating-financing-terrorism
[10] http://www.cgdev.org/working-group/unintended-consequences-anti-money-laundering-combating-financing-terrorism

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A link to CGD can be found here:
http://www.cgdev.org/

A link to the CGD report and the people who wrote it can be found here:
http://www.cgdev.org/sites/default/files/CGD-WG-Report-Unintended-Consequences-AML-Policies-2015.pdf

(14) On March 1, 2016 the House Financial Services Committee held a hearing entitled "Helping the Developing World Fight Terror Finance." While the hearing was oriented to improving global AML/CFT compliance, testimony by former Treasury official and current CCD visiting fellow Clay Lowery presented the CGD perspective.

His basic message was:

- don't drive transactions to less compliant institutions;
- consider the risk to the whole economy, rather than just the financial sector;
- assess the impact on financial inclusion; and
- don't over optimize compliance.

A link to the hearing can be found here:
http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=400338

A link to the committee summary memo can be found here:
http://financialservices.house.gov/uploadedfiles/030116_tf_memo_sup.pdf

A link to Clay Lowery's testimony can be found here:
http://financialservices.house.gov/uploadedfiles/hhrg-114-ba00-wstate-clowery-20160301.pdf

The Administration's Response

(15) Regulators' response to de-risking is to work with banks and host country regulators toward an enhanced understanding of the de-risking phenomenon; improved data collection; continued dialogue among stakeholders; timely implementation of the Financial Stability Board's 2015 action plan; communication of regulatory expectations; and continued strengthening of regulatory and supervisory frameworks with the help of technical assistance.

(16) It is not clear how quickly this approach will produce results. In June of this year the International Monetary Fund (IMF) released its paper on de-risking calling it a "case for policy action."[11]

In a speech on July 18, 2016 at the New York Federal Reserve, IMF Managing Director Christine Lagarde highlighted the report, drew attention to the de-risking problems faced

[11] http://www.imf.org/external/pubs/ft/sdn/2016/sdn1606.pdf

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by the Caribbean, and emphasized that the banking system needs to be made to work for everyone.[12]

In that speech, Ms. Lagarde did not seem optimistic that the solution to the de-risking is at all imminent:

> "The possibility of large penalties and reputational risks associated with enforcement on sanctions, tax transparency, and anti-money laundering seems to increase the costs of compliance for global banks in significant ways. Since these are the very issues where regulators have tried to provide clarity, this suggests that both sides still have some work to do in order to reach a better understanding."

(17) In a development that could accelerate de-risking, New York's Department of Financial Services finalized a set of AML rules that are stricter than those used at the Federal level and added a requirement that either board officers or senior compliance officers certify that companies' controls are adequate, potentially opening such individuals up to criminal liability if the controls are found lacking.[13]

The Congressional Response

(18) On June 29, 2016, the Task Force to Investigate Terrorism Financing of the House Financial Services Committee, after eleven days of hearings over a two-year period, introduced five bills to dramatically overhaul the government's AML/CFT enforcement.[14] Three of the five bills – HR 5594, HR 5607, and HR 5602 –passed the House under Suspension of the Rules and were sent to the Senate where they were referred to the Banking Committee.

Important from our standpoint is that HR 5594 – the legislation calling for a new strategy – would require much more of a partnership role between industry and government, and contains a provision that appears (though it never mentions the term) to require that the strategy deal with the issue of de-risking.[15]

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[12] http://www.imf.org/en/News/Articles/2016/07/15/13/45/SP071816-Relations-in-Banking-Making-It-Work-For-Everyone

[13] http://www.dfs.ny.gov/about/press/pr1606301.htm See also: http://www.wsj.com/articles/new-york-banking-regulator-to-publish-new-rules-to-prevent-money-laundering-1467244800

[14] http://fitzpatrick.house.gov/press-release/terrorist-financing-task-force-introduces-counter-terrorism-strategy

- HR 5594: Requiring the President to develop and publish an all-encompassing government strategy to combat money laundering and terrorism financing, promoting coordination among the pertinent federal agencies.
- HR 5607: Enhancing a number of tools that the Treasury Department uses in its efforts to combat the financing of terror, money laundering, and related illicit finance.
- HR 5603: Establishing a payment of rewards to individuals who provide information which leads to the freezing or recovering of funds stolen from developing countries through corruption.
- HR 5602: Authorizing the Secretary of the Treasury to include all funds when issuing certain geographic targeting orders, including funds involved an electronic fund transfer.
- HR 5606: Enhancing safe harbor provisions for information sharing among financial institutions and government agencies; broadening the range of suspected illegal activities, while requiring a study to determine the appropriate level of sharing with foreign subsidiaries or headquarters of U.S. banking operations.

[15] (5) THE ROLE OF THE PRIVATE FINANCIAL SECTOR IN PREVENTION OF ILLICIT FINANCE.—A discussion of ways to enhance partnerships between the private financial sector and Federal departments and agencies with regard to the prevention and detection of illicit money laundering finance, including—
(A) efforts to facilitate compliance with laws aimed at stopping such illicit finance while maintaining the effectiveness of such efforts; and
(B) providing incentives to strengthen internal controls and to adopt on an industry- wide basis more effective policies.

(19) Another significant legislative development was passage of United States-Caribbean Strategic Engagement Act of 2016 (HR 4939) in the House. That legislation would require the Department of State and the US Agency for International Development (USAID) to submit to the Congress a multi-year strategy to increase their engagement with the governments of some Caribbean countries.[16] De-risking is not identified as a topic to be addressed by the new strategy.

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[16] The bill directs the Department of State to submit to Congress a multi-year strategy for U.S. engagement with the Caribbean region that:

- identifies State Department and U.S. Agency for International Development (USAID) efforts to prioritize U.S. policy towards the Caribbean region;
- broadens State Department and USAID outreach to the Caribbean diaspora community in the United States to promote their involvement in Caribbean economic development and citizen security;
- outlines an approach to partner with Caribbean governments to improve citizen security, reduce illicit drug trafficking, strengthen the rule of law, and improve the effectiveness of the Caribbean Basin Security Initiative (CBSI);
- encourages efforts of the region to implement regional and national strategies that improve Caribbean energy security;
- improves diplomatic engagement with Caribbean governments; and
- assists Caribbean countries in diversifying their economies, reducing free trade and investment barriers, and supporting the training and employment of persons in marginalized communities.

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